Case

Sonance at a Turning Point

INTRODUCTION

In 2004, Scott Struthers and Geoff Spencer returned to Sonance, the high-end audio company they founded in 1982, to wrestle with a number of important decisions. After several years under the leadership of an outside CEO, Chip Brown, the loudspeaker maker seemed to have lost its strategic focus. Sonance had grown rapidly through the early and mid-1990s, positioning itself as an innovative designer of in-wall speakers sold exclusively through custom installation dealers. In the early 2000s, struggling to adjust to new, lower-priced competition, Brown pursued a strategy of diversification that reaccelerated growth but began to erode the company's brand equity with its core customer base. Struthers and Spencer, together with a new CEO, Shawn Sugarman, set out to plot a new course of action for their ailing company.

To help formulate and execute new strategy, Sugarman brought in a number of new executives, including chief sales officer Ari Supran, a 2004 graduate of Columbia Business School. Supran came to Sonance from Lutron Electronics Inc., the high-end lighting controls company. As residential marketing director at Lutron, Supran worked with the architect and interior design communities and had valuable experience marketing high-end lighting products to the luxury home market. One of Supran's first tasks at Sonance was to help develop strategy for the company to regain its leadership position in the industry. Supran joined in late 2005 and had less than a year to plan Sonance's relaunch at the CEDIA (Custom Electronic Design and Installation Association) EXPO, the industry's most prominent trade show. CEDIA EXPO was organized by a trade association of companies specializing in planning and installing home electronics systems and typically attracted over 25,000 custom installation dealers. Sonance wanted to unveil its revised mission and product lineup to its key constituency at this event. But before Supran and Sonance's management could focus on the CEDIA EXPO, they had to decide what the new mission and product lineup should be.

This case was written Natalie Mizik, Gantcher Associate Professor of Business, Columbia Business School. This case was prepared as a basis for class discussion rather than to illustrate either effective or ineffective or handling of a business situation. All proprietary company data are disguised to protect the confidentiality of parties involved. The author is grateful for the time and effort donated by Shawn Sugarman (CEO, Sonance) and Ari Supran (COO, Sonance) in the development of this case. Danielle Fox provided research and writing support. This case was originally published by Columb Caseworks of Columbia University as case number 080515. Used with permission.

ISSUES DEFINED

Slow Growth

The greatest challenge Supran and Sugarman faced going into 2006 was concern about the slow growth in Sonance's core product line of in-wall speakers. Some of Sonance's competitors began to focus more on sound-system integration, offering fancy touch-screen control systems, and used speakers as a loss leader. The control and video segments of the market were booming, but Sonance was not participating in this growth because speakers were its core offering and its main revenue source. In light of these trends, Sonance's management was deliberating whether to expand its product offering to tap the integration and controls segments or to revamp its existing line of speakers to make it more appealing.

Distribution Channels

From its inception, Sonance had focused on custom installation dealers who specialized in planning and installing electronic systems for luxury homes. The hard-earned credibility that the company had built with these professionals was now at risk: From 2000 through 2004, in an attempt to take advantage of the residential construction boom and strong retail sales growth, Chip Brown took the Sonance brand directly to new production home developers (builders of large-scale housing developments), as well as to the mass-market consumer through big-box retailers like Best Buy and Lowe's. This incensed the custom installers, who marketed their services to custom homebuilders, architects, and interior designers based on exclusivity of their product lines. Was this a problem, or was this a natural transition to a new channel structure in the changing industry? wondered the founders.

Consolidation Considerations

The consumer electronics industry had undergone a lot of changes since Sonance's founding. By 2005, audio equipment manufacturing had moved from the United States to China and the industry began to consolidate. The basic question of whether Sonance could and should proceed as an independent entity was at the top of everyone's mind. Shortly after joining Sonance, Sugarman surveyed the landscape and recommended that the founders sell the company. Its profitable niche seemed to be disappearing, the market share was shrinking under the assault of cheaper competition, and Sugarman worried that the founders were nostalgic for a past that was gone forever.

SONANCE'S FOUNDING AND DEVELOPMENT: BREAKING THE BARRIERS

Struthers and Spencer, two friends, hi-fi enthusiasts, and professional custom installers, founded Sonance in 1982 in San Juan Capistrano, California. They did something that was revolutionary in the audio industry at the time: they moved speakers off the floor and bookshelf and into the wall and ceiling. For the first time, consumers were able to enjoy music throughout their homes without compromising interior design and architectural considerations to accommodate bulky cabinet speakers. The focus on aesthetics allowed Sonance to develop cachet with high-end custom installation dealers. Exhibit 1 provides a timeline of major company events.

EXHIBIT 1 Timeline of Major Company Events

1982	Designs the first in-wall speaker for home customer installation
1983	Develops and markets Sonance 1 in-wall speaker model
1986	Invents the first in-wall subwoofer—unique dual driver speaker using vent technology
1988	Develops the first three-channel amplifier—bass, left, and right
1989	Introduced the first in-wall speaker with adjustable high-frequency control
1991	Develops Sonamp 260, the first amplifier for multiroom use
1994	Creates the first in-wall home theater speaker with pivoting tweeter
1997	Patents Amplified Volume Control technology for multiroom audio
1998	Launches the first THX Ultra in-wall speaker system
2000	Chip Brown becomes CEO upon the retirement of the founders
2001	Patents the SonicEye, a coaxially mounted, pivoting midrange and tweeter mechanism
2002	Invents the Ellipse, the world's first speaker designed specifically for in-ceiling home theater
	Introduces the world's first customizable multiroom amplifier—Sonamp SAT275 with SmartAmp bay for install module
2003	Develops the industry's first in-wall and in-ceiling high-fidelity speakers for extreme temperatures moisture, and marine environments—Symphony Extreme
2004	The founders become actively engaged in company management again and bring in Shawn Sugarman as CEO to replace Chip Brown
	Introduces the iPort, the first in-wall music system for the Apple iPod

Over the next several years, Sonance continued to introduce a number of innovative audio products and developed a reputation for selling sleek, technically sophisticated products. By the end of 1999, it grew to over $46 million in sales and 60 employees. At that point, the founders hired an outside CEO to run the company and took time away from the business.

Initially, when Struthers and Spencer just started the company, Sonance manufactured its speakers locally, partnering with a nearby cabinet-speaker maker in California to make its products. At the time, Sonance's Original Series in-wall speakers cost about $75 per pair to manufacture and sold for about $195 to its dealers, who sold and installed the speakers for a total price of $550 per pair to the consumer. The in-wall speaker category offered the dealers 65 percent gross margin on the hardware, the highest among the product categories they sold.

This local manufacturing arrangement lasted for about 10 years, at which point Sonance's manufacturing partner decided to enter the in-wall speaker market and began to sell speakers virtually identical to Sonance's, but at lower prices, under the SpeakerCraft brand name. Sonance moved its manufacturing to Asia, which reduced its manufacturing costs.

SpeakerCraft quickly emerged as a serious threat to Sonance's growth and profitability. After a protracted legal battle over copyrights, Sonance lost its case against SpeakerCraft, in part, due to poor legal advice. Sonance and SpeakerCraft battled for market share through the 1990s, and Chip Brown was recruited as CEO in 2000 to help stem Sonance's declining sales. By 1999, the competition drove Sonance's speaker price to consumers down to $400 per pair, while a pair had COGS (Cost of goods sold) of about $50 and sold to dealers at $140. Brown immediately refocused Sonance's strategy on two rapidly growing customer segments—mass-market

EXHIBIT 2 Sonance's Key Revenue Sources

Business line	*Year 1999*	. . .	*Year 2003*	*Year 2004*
Dealers:				
Number of dealer accounts	1,000		600	500
Average selling price per pair	140		140	140
Dealer revenue ($)	42,000,000		25,200,000	21,000,000
Mass Merchandisers:				
Average selling price per pair			120	120
Best Buy revenue ($)			10,000,000	10,000,000
Lowe's revenue ($)			6,000,000	withdrawn
Other Retail (hi-fi Boutiques):				
Number of outlets	127		221	289
Average selling price per pair	140		140	140
Revenues for the small retail ($)	3,000,000		4,500,000	5,500,000
Production Housing Builders:				
Number of production builder accounts	8		85	125
Price per pair of speakers	140		90	90
Builder revenue ($)	1,075,200		7,344,000	10,800,000
Total Revenue all Categories ($)	**46,075,200**		**53,044,000**	**47,300,000**

Source: Company data.

consumer electronics retailers and production home builders. At the time, Best Buy was growing annually at over 20 percent in sales and nearly 15 percent in square footage. Although new home sales were choppy in early 2000 amid rising interest rates, they were showing signs of recovery and ended the year up 13 percent. Brown responded to these trends by directing Sonance to sell its products directly through mass merchandisers and large production builders.

The retail and production builder strategy helped reinvigorate sales, bringing Sonance's revenues to $53 million by 2003, but it disenfranchised Sonance's traditional customer, the custom installer. SpeakerCraft's sales reps eagerly snapped photos of Sonance's products sitting on Best Buy's shelves and shared these photos with Sonance's high-end audio dealers. By 2004 Sonance had only half the 1,000 dealer accounts it had in 1999, as high-end installers dropped Sonance's products from their portfolios. Revenue was still high thanks to Best Buy, Lowe's, and builders, and the founders were content with earnings. But in 2004, after Lowe's decided to exit the in-wall speaker category, Sonance's sales dropped to just above $47 million. It was time to reassess the company's position and strategy. Exhibit 2 shows the change in revenue by distribution channel.

INDUSTRY: HIGH-END AUDIO

High-performance audio, also known as "hi-fi" or "high end," falls within the audio segment of consumer electronics. It includes preamplifiers, sound processors, power amplifiers, speakers, turntables, disc players, radio tuners, cabling, and accessories. The heyday of hi-fi was in the 1970s, when Vietnam veterans brought components back from Asia and introduced high-quality sound systems to the mainstream consumer.

Consumer Electronics Association (CEA) defines high-performance audio as "the premier category of home audio products that reproduce music so realistic that it sounds like a live performance."[1] For a long time, mass-market audio products lacked the musical accuracy of high-performance systems; but eventually performance differentials narrowed. The marginal benefits of technical improvements began to diminish, leading some high-end audio companies to focus more on other product attributes, including integration, controls, and aesthetics.

According to the U.S. Census Bureau, there were $101 billion in consumer electronics retail sales in 2004, up 7.7 percent from 2003, and the forecasts predicted continuous growth for the next few years. Between 1990 and 2004, the industry's annual growth rate averaged 6.7 percent. A combination of product life cycle and economic factors drives the overall demand for consumer electronics: The drop in average selling prices for personal computers helped drive explosive industry growth in the mid-1990s, while sagging consumer confidence and job losses were blamed for slow industry growth in 2000 and 2001.

When Sugarman and Supran teamed up to redirect Sonance, the audio segment of the consumer electronics industry had about $5.6 billion in factory sales and had been teetering on decline for several years (Exhibit 3 on page 568). Industry observers attributed the slump to the lack of product innovation, difficulty conveying product features to consumers in most retail settings, and greater interest in video-related categories. However, there was hope that the shift from analog, tube TVs to digital, flat-panel TVs would spur overall category demand in the near future.

TRADITIONAL CHANNEL: CUSTOM INSTALLATION DEALERS

Most high-end audio purchases were made through specialty retailers and custom installers. The need to tailor the product to accommodate environmental issues like room features made for a highly consultative sale. As a result, the CEA recommended consumers to work with a specialty audio dealer to design and install an audio system. Unlike mass-market sales, high-end sales usually required installation by a custom installer.

Few large custom installation companies with satellite locations throughout the country operated in this space. Some, like Modia and HiFi House, were hybrid retailers, a mix of retail outlets and consulting services. Others, like Audio Command and Audio Video Systems, were custom-only installers. In 2005 the largest 100 custom installation companies logged gross revenues of $703.8 million, and the whole custom installation industry revenues were over $10 billion.[2] The median revenues for a custom installation dealer, however, were around $737,900 in 2005[3] as the majority of custom installation dealers were small businesses with five full-time employees, two or three of whom were master installers and one or two of whom were sales/design personnel. In busy times, dealers typically hired independent contractors to help with installation, but with the housing boom, by 2005, it became virtually impossible to find qualified independent professionals willing to take on ad-hoc projects. Housing growth attracted new entrants, with nearly one-third of custom installation companies surveyed in 2004 operating for less than five years. The custom-only installers tended to have strong ties to the architectural community. Many belonged to CEDIA, the trade group that provided certification and held annual trade shows.

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[1] "What Is High-Performance Audio?" CEA.com, downloaded September 2008.

[2] Jason Knott, "CE Pro 100 Reports 104% Jump in Install Price," *CE Pro Newsletter* (May 1, 2007).

[3] "State of the Industry Special Report," *CE Pro Magazine* (January 2007).

EXHIBIT 3 **Total Factory Sales of Consumer Electronics (Millions of Dollars)**

	2000	*2001*	*2002*	*2003*	*2004*	*2005E*
TV, Video Players	17,927	16,607	18,505	19,267	21,654	26,095
Home & Portable Audio Products	6,323	5,726	5,111	4,779	5,531	5,650
Mobile Electronics	17,071	16,799	16,188	17,184	19,007	20,150
Home Information Products	36,855	34,923	33,504	38,282	41,433	44,238
Blank Media	2,169	2,679	3,210	3,750	5,255	7,947
Accessories & Batteries	6,299	5,968	6,460	7,041	7,545	8,275
Electronic Gaming	8,550	9,689	10,848	10,253	10,970	11,122
Home Security	1,750	1,820	1,965	2,055	2,150	2,250
Grand Total	**96,944**	**94,211**	**95,791**	**102,611**	**113,545**	**125,727**

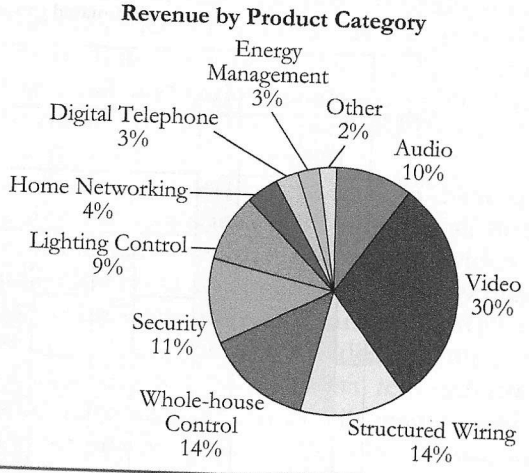
Select Detail on Total Factory Sales of CE (millions of dollars)

	2000	*2001*	*2002*	*2003*	*2004*	*2005E*
TV, Video Players						
Analog Direct-View Color TV	6,503	5,130	5,782	4,756	3,505	1,311
Analog Projection TV	1,481	1,060	733	293	85	18
Monochrome TV	15	15	12	9	5	4
Digital Direct-view and Projection TV	1,355	2,485	3,574	4,351	6,099	11,046
LCD TV	107	101	246	664	2,022	3,074
Plasma TV	-	116	515	1,590	2,518	3,558
TV/VCR Combinations	968	790	733	778	665	349
Videocassette Players	14	5	4	2	2	1
VCR Decks	1,869	1,058	826	407	134	75
Camcorders	2,838	2,236	2,361	2,002	1,701	1,649
Direct to Home Satellite Systems	790	1,175	1,116	1,476	1,886	1,776
Personal Video Recorders	77	144	57	178	541	682
Separate Component DVD Players	1,717	2,097	2,427	2,698	2,460	2,538
Set-Top Internet Access Devices	193	195	119	63	31	14
Total	**17,927**	**16,607**	**18,505**	**19,267**	**21,654**	**26,095**
Home & Portable Audio Products						
Rack Audio Systems	84	42	17	9	2	1
Compact Audio Systems	1,776	1,357	965	731	900	769
Separate Audio Components*	1,545	1,261	1,202	981	1,140	1,064
Home Theater-in-a-Box	331	794	896	961	971	983
Portable Equipment	2,156	1,846	1,526	1,355	980	889
Portable MP3 Players	80	100	205	424	1,204	1,653
Home Radios	351	326	300	318	334	291
Total	**6,323**	**5,726**	**5,111**	**4,779**	**5,531**	**5,650**

*Includes speakers

Source: Consumer Electronics Association, January 2005 CE Sales and Forecasts

EXHIBIT 4 Custom Installation Dealer Sales by Product Category in 2005



Source: Company estimates based on CEDIA Member Survey 2005.

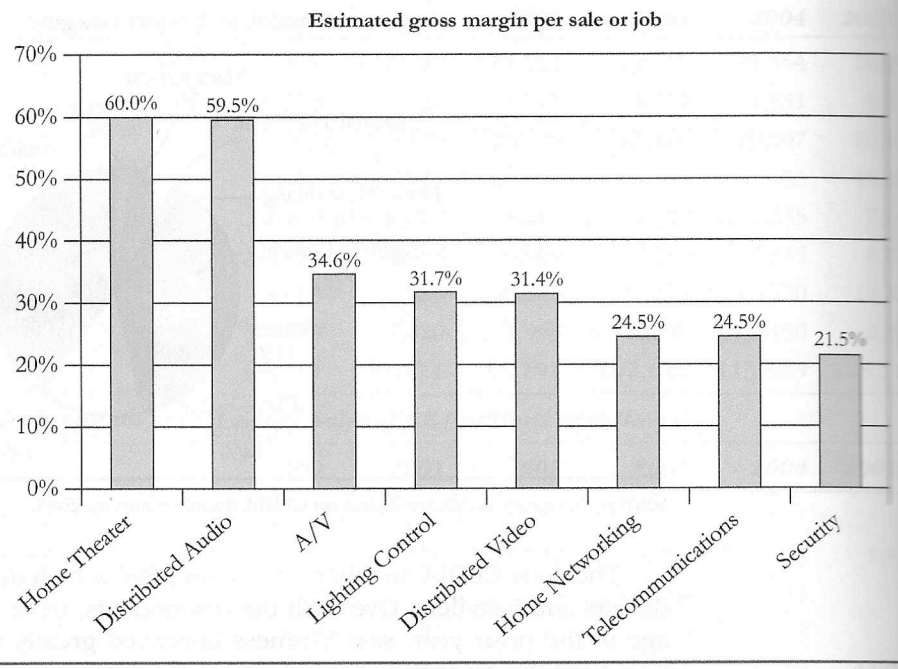
The 2004 CEDIA Member Survey revealed a high degree of optimism among dealers and installers. Over half the respondents, more than double the percentage in the prior year, said business improved greatly from 2003. CEDIA members typically managed comprehensive installation projects that included audio, video, lighting control, home networking, structured wiring, digital telephone, whole-house control, security, and energy management systems (Exhibit 4). Each such project typically took about three weeks to complete. CEDIA members reported in 2004 sales increases in distributed audio and video categories and Sonance's management estimated that a total of almost 100,000 homeowners had used dealer's services to install in-wall speakers. But looking ahead, the dealers were most bullish on home networking and security.

Most custom installation dealers were given a budget by their client and asked to provide a complete home theater and multiroom audio and video distribution system for the home with an extended warranty on labor and hardware within that budget. It was typically a part of a much larger new building or renovation project coordinated by an architect or interior designer, who sought out a custom installer to handle the audio and video portion. The budget could vary anywhere from $25,000 up to $1 million plus. A custom installer's average budget was about $100,000 with about 8 percent going to the speakers.

It was typically up to the dealer to decide how to distribute a client's budget across home control systems, speakers, amplifiers, televisions, and video projectors, and to plan for the installation. In-wall and in-ceiling speakers typically offered dealers the highest profit margin of any category with gross margins of 60 percent plus (Exhibit 5 on page 570). Margins on video, which typically took a large share of the project's budget, were lower and dropping to below the 30 percent range. Control systems averaged 50 percent but required a lot of after-sales support because they often needed to be reprogrammed as consumer needs changed over time. In-wall and in-ceiling speakers were one of the few products dealers could install and forget about as they rarely broke and did not need to be serviced or programmed.

Until 2000, Sonance maintained relationships with about 1,000 dealers. These relationships were nonexclusive as dealers carried several competing brands to accommodate designers' wishes and clients' budgets. Each of Sonance's dealers used Sonance speakers in about 15 major projects per year with an average job

EXHIBIT 5 Custom Installation Dealer Profitability by Product Segment in 2005



Source: Company estimates based on CEDIA Member Survey 2005.

requiring 20 pairs of speakers. In 2000, about 150 of Sonance's 1,000 dealers operated primarily at the highest end of the luxury housing market and undertook only $500,000 plus projects, which typically involved larger properties and required over 30 to 40 pairs of speakers.

Before 2000, Sonance acquired dealer relationships through in-house training programs and networking events and had a 95 percent account retention rate. But the dealers began to defect once Sonance moved into the production builder and retail markets, and acquiring new dealer accounts became increasingly difficult. In 2004, Sonance had only 500 dealer accounts as more and more resentful installers turned elsewhere for high-end speakers. Sugarman noted, "We go into some of the most expensive homes in the world. We were one of the first luxury custom installers in the world." And Supran added, "We depend on word-of-mouth among dealers, and reputation is the greatest asset. Custom installers don't have store fronts; they have high-end appointment-only showrooms. With the move to the mass-market and the production housing segments, we lost both great customers and great employees."[4]

SONANCE'S CUSTOMERS

Mass Market: The Retail Consumer

According to CEA research, the vast majority of the home audio sales fell into three categories: home theater in a box (HTIB), A/V receiver (AVR), and A/V receiver plus speakers. Altogether, they accounted for an estimated $9 billion in annual retail sales in 2004. There were some key differences among the categories.

[4] Interview with Sonance management team, San Clemente, California, August 2008.

but to buyers in all three categories, price and sound quality were very important and buyers often went online to research products. The average amount spent in 2004 was about $650 for HTIB, $450 for AVR, and $600 for AVR plus speakers. The spending, however, varied significantly. It was typically well above average in specialized retail outlets, above average at the general electronics stores (which were the top retail destination for home audio purchases), and below average at mass merchants (the next most popular outlet). The retail customers typically installed the products themselves.

Chip Brown put Sonance's sales force to task in 2000 to acquire new retail accounts and place the company's in-wall speakers at all three retail categories, from the discount mass-merchandisers to high-end audio-video boutiques. Best Buy and Lowe's were the largest retail accounts, bringing in $9 million and $6 million, respectively, in 2003. Sonance speakers sold particularly well at Lowe's as most of Lowe's consumers were not intimidated by the idea of cutting out a hole in the drywall to set up their speaker system. The additional revenues from the mass market, however, came at a cost to Sonance's profitability as the average selling price per pair of the Original Series speakers, Sonance's main product, was reduced to $120 to acquire these accounts.

Brown had also expanded the R&D department and funding and directed 50 percent of the $3 million annual R&D budget toward the development of new nonspeaker product ideas. The hope was to refocus the pipeline and eventually develop products that could be suitable for retail consumer. This R&D effort had germinated by 2004, most notably, with the development of iPort, an in-wall docking station for Apple's iPod.

Production Housing: New Home Owners

Sonance successfully tapped the new construction market under Chip Brown. While this segment was dominated by SpeakerCraft and Bose, the housing boom and high growth in new production housing starts provided opportunities for Sonance to carve a share of this market. A typical production housing project consisted of 80 to over 150 semicustom housing units. The builder allowed the homeowner to customize some of the house features and provided a menu of options. To develop a menu, the builder signed exclusive deals with vendors to deliver the upgrades if requested by the homeowner. The homeowner had a choice whether to request an upgrade option or not. If requested, the installation was performed by the builder at the time the house was built. About half the homeowners selected the distributed audio option when it was offered and, on average, each of Sonance's production development accounts provided 80 installation jobs, each requiring 10 to 14 pairs of speakers. Developers liked the partnership because they could advertise the "fully wired for distributed audio" option to prospective home buyers.

Before Brown, Sonance did not actively pursue production housing and, in 1999, sold its speakers to only eight production housing projects. These were higher-end production developments, and the dealers purchased speakers from Sonance at $140 a pair. Most developers, however, wanted to offer distributed audio option at a very low cost to the homeowner to make the overall home value appear attractive. To make its products more suitable to production property developers, Sonance had to provide "quantity discounts" for large development projects and soon came to accept a $90 sales price per pair of speakers, matching the sale price of its main competitor, SpeakerCraft..

Production housing segment was growing the fastest in the Sonance portfolio. By the end of Brown's tenure in 2004 Sonance had 125 production developer accounts, a 47 percent growth over the prior year. Sales in 2005 were headed for

another record with 180 deals with developers, and the sign-ups with developers for 2006 delivery were already up almost 40 percent over the 2005 numbers.

There were some clear economies of scale for Sonance to work with production builders because one salesperson could manage and pursue multiple large accounts. However, builder relationships were not as stable as those with custom installation dealers. While each builder account provided a large one-time sale, there was little repeat business as each new development project was courted by multiple audio vendors, who bid on the right to serve the entire development.

Custom Designer Homes: High End of the High End

Working as professional custom installers in the 1980s, Struthers and Spencer noticed that affluent home buyers wanted advanced sound systems, but they objected to the clunky look of tower speakers. At the time, the hi-fi audio segment of the consumer electronics industry was dominated by technology enthusiasts rather than design experts. From its inception, Sonance focused exclusively on a niche within high-end audio and emphasized superior design rather than acoustic superiority in order to fill this gap in the market. Sugarman summed up Sonance's mantra: "What Sonance did, changed the relationship between audio and architecture. We put a hole in the wall with a hammer and the customer loved it! We built a brand around the aesthetics of the product."[5]

Sonance invented the category that scored the highest marks on what was known in the industry as the WAF (Wife's Approval Factor) scale. Supran explained:

> Typically the man demands high-end audio equipment. If you ask our consumers what they want in their home audio system, they always say best sound quality. And there is no question that high-end tower and ribbon speakers provide the best sound quality. But when it comes down to placing tower speakers in the design-oriented luxury homes, the lady of the house, who often has spent countless hours working with the architect and interior designer to match the layout, furniture, the color scheme, and accessories, is not too pleased with such prospect. When it comes down to selecting the speaker system, the look and style come to the forefront.[6]

The typical custom homeowners were usually wealthy couples in their fifties. Many were technology entrepreneurs, hedge fund managers, or investment bankers. Sonance's products found their way into the homes of the rich and famous. This clientele wanted everything top-notch and took superior technical specifications as a given.

Whether sales were to custom installers or to production builders, it took some time to translate contracts into dollars. With individual homeowners, buyers first had to engage an architect to draw up plans for their new structure or major renovation. Sometimes the architect would include the sound system, but sometimes that came later, when an interior decorator got involved. Months later, as construction began, the architect or design professional would seek out a custom installer. Then the custom installer would place an order with Sonance or one of its competitors five to six months in advance of needed delivery date. Working directly with builders cut out the custom installer as the builder's employees or subcontractors performed the installation. But builders often took much longer to get projects under way after signing the deal because they needed to secure zoning and financing. Once Sonance delivered the product, it usually took three to four months to receive payment.

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[5] Interview with Sonance management team, San Clemente, California, August 2008.

[6] Ibid.

COMPETITION: FACING LARGER PLAYERS

Competition in consumer electronics was intense with large Asian manufacturers dominating the industry. In the mass-market retail in-wall speaker category, key competitors included Yamaha, Bose, Polk, Klipsch, and Boston Acoustics. In the production developer segment, Bose, Niles, SpeakerCraft, and Sonance were the key players. The custom installation segment was dominated by B&W, Niles, Meridian, Linn, Elan, SpeakerCraft, and Sonance.

Some of Sonance's competitors were large, with more diversified revenue bases and significant research and development budgets. Sonance's archrival, SpeakerCraft, seemed to be growing larger and more powerful. In 2003, SpeakerCraft was acquired and became a subsidiary of Nortek, a diversified manufacturer of residential and commercial building products with about $1.5 billion in annual sales. Nortek used a portion of the $625 million it raised through a private placement with Thomas H. Lee Partners L.P. in the early 2000s to acquire three of Sonance's competitors (Niles, Elan, and SpeakerCraft), making its residential audio products division four times as big as Sonance's. It was this changing competitive landscape and intensifying price competition that led Sugarman to question whether Sonance could continue as an independent company.

"Once again we are the industry leader in the In-wall, In-ceiling speaker category at almost twice the percentage of our closest competitor," boasted SpeakerCraft on its Web site in 2005. It highlighted its manufacturing role in the advent of in-wall speakers and characterized its break from Sonance as a quest for quality. SpeakerCraft actively promoted its bracketless in-wall speakers, which were easier and faster to mount. It had also just introduced flush tweeters and speakers that could pivot, which significantly alleviated placement concerns.

While for a long time SpeakerCraft's speakers were virtually identical to Sonance's, in the late 1990s, SpeakerCraft streamlined its speaker design eliminating the mounting brackets. This redesign reduced SpeakerCraft's manufacturing cost for a pair of speakers to $40. SpeakerCraft sold a pair of speakers to the dealers at $90, who in turn installed the speakers for a total price of $365 to the consumer. SpeakerCraft promoted its product to the dealers emphasizing the 75 percent gross margin the dealer received on hardware sale and the easier and faster installation. While it took on average one hour and $60 in labor cost to install a pair of Sonance's speakers, SpeakerCraft's speakers could be installed in half that time, allowing the dealer to save $30 in installation costs.

With SpeakerCraft shifting its focus from pricing to design features, competition at the high end was becoming increasingly intense. Supran and Sugarman realized that SpeakerCraft's latest generation of speakers would be very appealing to installers because it offered higher margins and cheaper installation than Sonance's products.

CONTEXT: TIED TO THE BROADER ECONOMY

Consumer electronics sales are closely tied to consumer confidence and the housing and labor markets. The housing market and its luxury segment were experiencing strong growth and Coldwell Banker, one of the nation's leading real estate brokerage firms, reported a 47 percent increase in $1 million plus home sales in 2004. According to CE Pro, custom installers derived about 60 percent of customer installation revenues from new construction in 2004. The remaining 40 percent came from remodeling and retrofitting. Remodeling segment tended to be particularly sensitive to greater economic trends. The luxury designer new

housing ($7 million plus properties), on the other hand, seemed less affected by economic fluctuations. Of the new construction, Sonance estimated that each year about 2,500 houses falling into the luxury designer home category installed in-wall speaker products, and Sonance had about 25 percent of this market with its Original Series.

NEW PRODUCTS

Sonance's R&D department had a few new product ideas in the works and two projects, a modified iPort and the new in-wall "Architectural Series" speakers, were close to completion. Supran and Sugarman knew they had to prioritize development effort as time was running out and Sonance did not have resources to bring both products to the market by September 2006.

IPORT

In 2004, Sonance introduced the iPort, an in-wall docking station for the Apple iPod (Exhibit 6). It had a list price of $598 and was sold exclusively through custom installation dealers, who paid Sonance $300 per unit. It cost on average $150 to install. *PC Magazine* described the iPort as follows:

> If you have to ask how much yacht fuel costs, you probably can't afford to put that big a boat in the harbor. The same holds true, on a smaller scale, for the Sonance iPort, a gorgeous in-wall cradle and stereo connector for Apple iPods that costs two or three times what you pay for an iPod in the first place. But it's a beautiful device for moving iPod-resident audio to your stereo system.[7]

Sugarman wondered if maybe there was a way to adapt the iPort for the mass market and tap into the explosive demand for iPods. Target, in particular, was rumored to be making a bigger push into consumer electronics. With the discount store's emphasis on style, it seemed like a good fit with Sonance's design expertise. Having access to Target's nearly 1,400 stores could potentially quickly recoup the $6 million in lost revenues after Lowe's dropped the in-wall speaker category. But would the Target shopper accept iPort's price tag? Another challenge was making the iPort installation easier so that a consumer could handle it without the help of a professional installer.

Sugarman and Supran met with the iPort design team. The engineers confirmed that they could redesign the in-wall iPort to be detached from the wall so that the unit could be integrated with the consumer's home audio system. They could also eliminate the remote control and power surge features, which would lower manufacturing cost per unit from $150 to $125. This would allow Sonance to sell a consumer version of the iPort to the retailer at $240 to $250, which with the 33 to 40 percent retail margins, would keep the retail price at around $330 to $350. This was definitely an improvement, but the iPort, technically an accessory, would still be more expensive than most iPod models. In 2005 Apple has taken off $50 from the prices of existing iPod models: a four-gigabyte iPod was selling at $199 and the new six-gigabyte version went down to $249.[8]

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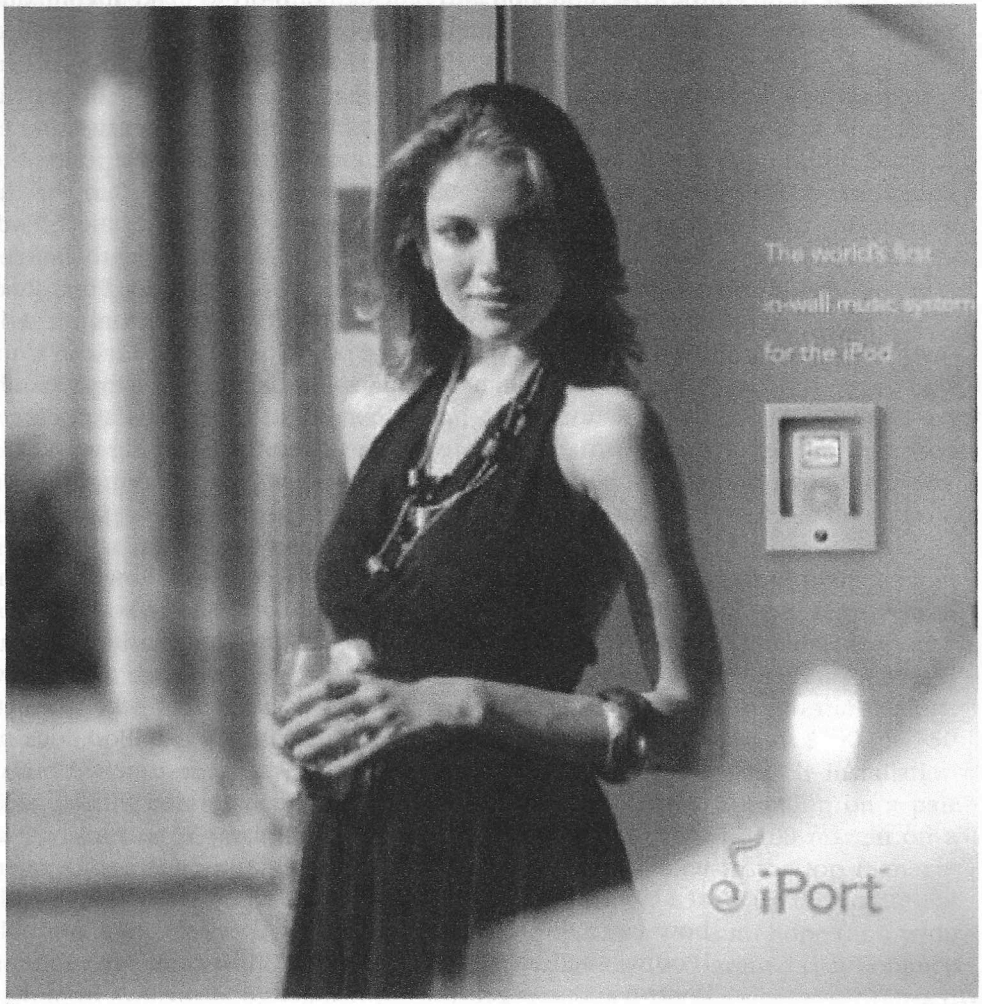
[7] *PC Magazine* online, March 9, 2004.

[8] "Apple Lowers iPod Prices," *WebProNews* (February 24, 2005).

EXHIBIT 6 **iPort**



How it works

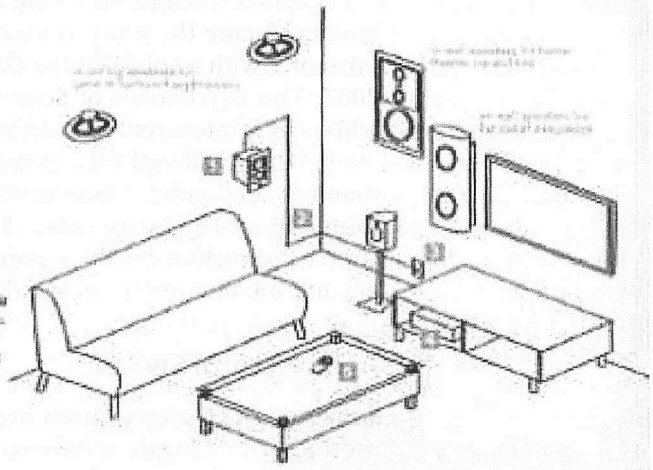
1 The iPort In-Wall is installed into a wall and permanently affixed. Similar to a wall switch it is integrated into an environment.

2 Power, music and video sources are all routed to an iPort Wallplate.

3 The iPort Audio Wallplate provides power to the iPort from an off-board DC power supply. RCA, RS-232, RJ-45 connections provide connectivity, and a Video Wallplate provides video to a display device.

4 An audio or video system controls the iPort output to loudspeakers or video monitors.

5 Optional items include an iPort Remote Control and other system connectivity kits to make your iPort powerfully convenient.



Simplifying installation of the iPort was another challenging task. Sonance's engineers estimated that they would need an additional $1,225,000 to undertake the cost reduction and redesign of iPort to make it compatible with non-Sonance audio systems and an additional $400,000 to complete all compatibility and consumer safety tests. But even then, the installation and integration would still require about an hour and a half of time for a "technically adept" consumer. The plug-and-play design was simply not feasible because the entire home audio system would likely need to be reconfigured to incorporate the iPort device.

Sonance's tiny marketing group was very enthusiastic about the iPort and strongly supported its development. In 2004, Apple's iPod accounted for about half of all MP3 sales and 2005 iPod sales were clearly headed through the roof. In its just released 10-K statement, Apple announced that it sold 22.5 million iPods in fiscal year 2005, an increase of 409 percent from the 4.4 million iPods sold in 2004.[9] About 47 percent of iPod unit sales were in the United States. It had now shipped more than 30 million iPods since the first member in its MP3 player family launched in November 2001. While iPort's pricing and installation were of concern, if Sonance did not enter the booming market in 2006 it might never have such an opportunity again. The iPort R&D group guaranteed that if it were fully funded, the iPort could be ready to go into production by September 2006, just in time for the CEDIA EXPO and the holiday shopping season.

The question that concerned Supran was how to estimate potential demand for the consumer version of the iPort. The in-wall iPort sales through dealers could, at best, be described as sluggish, but marketing argued that dealer orders were no indication of the consumer acceptance of the new detached iPort version. The other concern Supran had was that several electronics manufacturers and most of Sonance's competitors already had iPod docking stations on the market. Some models were sold with speakers attached but others, like Sonance's in-wall iPort, sold as an add-on to be integrated with a specific brand of the audio system. SoundDock from Bose, for example, was a single dock-and-play unit integrated with two speakers and was on the market for over a year. It was priced at $199 to $399 and seemed to be sold everywhere, but there were no data on how large the sale numbers were. Altec Lansing's portable docking station for iPod was selling for $150 at CompUSA. It came with four speakers and a remote control and was getting surprisingly good reviews from the users.

Sonance's marketing group was bullish on the iPort and asked for a $3.5 million budget to take the iPort to mass market for the holiday shopping season and to present it with a splash at the Consumer Electronics show in Las Vegas in January 2007. The key benefit of Sonance's detached iPort, marketing argued, was that while labor intensive, it could be integrated with most brands of home audio systems. What bothered Supran was that his marketing colleagues did not have hard numbers, beyond pointing to iPod's explosive growth, to justify their enthusiasm for the iPort. He also wondered whether the investment in the iPort was the right strategic direction for the company. This would be the first true consumer product and the first ever mass-market marketing campaign for Sonance.

Architectural Series

Sonance's R&D department was also working on a radical redesign of its core product, the in-wall speakers. By late 2005, the design team had the prototype for the first truly flush-mount trimless speaker that completely eliminated

[9] Apple Computer Inc. 2005 10-K report.

sightlines. The new advanced bracket held the speaker perfectly flush with the wall surface, and the speakers were literally invisible and could be painted or wallpapered over. Sonance called this model the Architectural Series, and some in the company believed that Sonance was on the brink of a breakthrough innovation.

Supran and Sugarman met with their speakers R&D team and designers in late December 2005. The engineers estimated that it would cost additional $2 million to finish the development of the Architectural Series and be another half a year before the Architectural Series can go into production. They estimated that a pair would cost about $200 to manufacture and warned that installation would be more involved and more expensive than for the Original Series. Installing new speakers would require two full hours of a master installer's time and cost about $200, as master installers charged $90 to $110 per hour.

The initial focus groups with architects and designers indicated that the owners of high-end custom homes simply wanted the best and, within reason, cost was not a concern for their clients. The designers indicated that they would expect to pay at least $2,000 per pair for totally flush speakers. Supran was excited about this finding. He suggested offering the dealers a 65 percent margin and setting the price to the consumer at $2,500. Supran thought he could use the custom installation dealers to move the product to the right clients.

Supran's enthusiasm was not shared by some in the top management team. The marketing team, in particular, argued that the high-end luxury market was too small, and that dealers would not accept a $2,500 ticket price after SpeakerCraft had driven consumer prices for in-wall speakers to the mid-$300 level and was offering 75 percent gross margins and easy installation to the dealers. Marketing guesstimated that the best Sonance could hope for was a $740 to $750 price to consumers, which would allow the dealers to cover their installation cost of $200 and to make the $245 profit they were used to getting on a pair of SpeakerCraft's speakers. This would leave Sonance about $100 margin on a pair of Architectural Series speakers. But there were some in the top management team who thought that Sonance would not be able to recoup the additional development costs even at the $750 price, and that there was no hope for a wide market acceptance—this was clearly a niche product. They argued that Sonance should cut its losses and scrap the Architectural Series project before it burned through even more cash. The simple reality was that the high-end dealers had turned away from Sonance.

Supran knew that if Sonance were to launch the Architectural Series, his sales team would need to gain back the high-end custom installers who discontinued Sonance's speaker line during the Chip Brown years. He pondered the challenge. He knew he had to run through the numbers to evaluate the options. It had been three years since he took the final exam in his Marketing Strategy core course at Columbia Business School, but the basic concepts of break-even, economic value to the customer, and the lifetime value of a customer were suddenly more useful than ever. Was his enthusiasm about the Architectural Series unjustified and the $2,500 price unreasonable? Was he too cautious about the consumer iPort simply because he did not have expertise in mass marketing? How large was the iPort's potential? How much was a production developer versus a custom installation dealer worth to Sonance in the long run? What was the right long-term strategy for Sonance? Supran knew that some of these questions can be easily answered with the back-of-the-envelope calculations. For others, however, he did not have enough reliable data and had to make assumptions. He had to propose and justify a profitable growth strategy for Sonance or, he knew, Sonance's future as an independent company was in jeopardy.

THE OPTIONS: ANALYZING ALTERNATIVES

As 2005 drew to a close, Sugarman and Supran had to prepare their plans for 2006 and the CEDIA EXPO. They were facing some tough decisions. Sonance began with a narrow focus on custom installers, but now it was also selling speakers to production builders and through mass merchants. Diversification had led to fast overall growth, but resentment among custom installers had eroded sales and market share in the high-end custom installation business.

Time was running out for Sugarman and Supran: they had to make an executive decision. Should Sonance try to mend its relationships with and recommit to its historical base of high-end custom installers? Should it introduce the Architectural Series and at what price point, $750 or $2,500? Should it more aggressively pursue the large-scale new production construction with the Original Series? Or should the company focus on the retail consumer markets and put full support behind the iPort redesign and marketing?

Whatever strategy Sonance pursued, it had to have all product development completed and marketing plans finalized to be ready for launch at the CEDIA EXPO, less than a year away.